EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2006 and 2007

Autumn 2006

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, www.efn.uni-bocconi.it or by e-mail at efn@uni-bocconi.it .

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Report closed on 22 September 2006

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Highlights

- The global economy has continued to expand briskly in the summer of 2006, but in the second half of this year and in the first half of 2007, the upswing of the world economy will lose momentum in the wake of slower growth in the US. In addition, monetary policy has become less expansionary in all important countries, threatening the widespread housing market boom. Finally, fiscal policy will be slightly restrictive in the US, in the euro area, and in Japan in 2006 and 2007.
- In the first half of 2006 output in the euro area expanded at the fastest pace in five years, with particularly strong investment activity. Firms have at last reacted to conditions that have been beneficial for the past two years: cheap capital due to low real interest rates and rising equities, and a moderate growth in unit labour costs.
- Demand in the euro area will expand at a more moderate rate in the second half of 2006 and in the beginning of 2007: exports will suffer from the appreciation of the euro relative to dollar and yen during spring and summer 2006, and from weaker stimuli from the world economy, in particular from the US. Economic policy will dampen as well: the ECB appears to be determined to reach a neutral monetary stance quickly; and in 2007 fiscal policy will be clearly restrictive in Italy and in Germany.
- Conditions in the labour markets, however, will further improve, due to reforms in some countries and wage moderation in the past few years. As a consequence, consumer confidence is strengthening and will ultimately support private consumption. Therefore, after a weak spot in the coming autumn and winter, growth in the euro area will recover.
- Our forecasts for GDP growth in the euro area are 2.4% in 2006 and 1.8% in 2007. Industry and market and financial services will be the motor of growth from a supply side perspective. Industrial production will grow by 3.5% in 2006 and 2.5% in 2007, driven by capital goods.
- The forecasts for headline and core inflation in the euro area for 2006 have been revised downwards, to 2.2% and 1.4%, respectively. Considering the impact on euro area inflation of the three percentage point increase in the German VAT rate, and assuming that 80-85% of the rise will be transferred to consumer prices, our headline and core inflation forecast for 2007 are around 1.9% and 1.7%, respectively.

Table 1 Economic outlook for the Euro area

	2003	2004	2005	2006 1st half	2006: annual		2007: annual	
					Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
						2.2		1.3
GDP	0.8	1.9	1.4	2.4	2.4	2.5	1.8	2.3
						-0.5		-0.8
Output Gap	-1	-1	-1.1	-0.3	-0.2	0.2	-0.2	0.3
						1.6		1.7
Private Consumption	1.2	1.5	1.3	1.8	1.9	2.1	2.5	3.3
						1.6		0.4
Government Consumption	1.8	1.2	1.4	2.2	1.7	1.9	0.8	1.2
						3.3		1.0
Fixed Capital Formation	1.0	2.1	2.7	4.0	4.0	4.5	2.9	4.8
						7.7		4.9
Exports	1.1	6.8	4.2	8.9	8.3	8.9	5.9	7.4
						7.6		5.4
Imports	3.1	6.7	5.3	8.7	8.2	8.8	7.1	8.8
						7.6		6.5
Unemployment Rate	8.7	8.9	8.6	8.0	7.7	7.7	7.3	7.4
						2.4		3.6
Labour Cost Index	3.1	2.3	2.2	2.2	2.5	2.7	3.9	4.6
						1.0		0
Labour Productivity	0.4	1.3	0.7	1.4	1.1	1.3	0.4	0.7
						2.1		1.5
HICP	2.1	2.1	2.2	2.4	2.2	2.3	1.9	2.3
						2.7		1.2
IPI	0.3	2.0	1.2	3.6	3.5	4.3	2.5	3.8

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2006 and 2007

The world economy: a changing face

The global economy has continued to expand briskly in the summer of 2006, but the spatial distribution of the driving forces has started to change: on the one hand, the economy in the euro area has gained strong momentum in the first half of the year, and exporters of oil and of other raw materials have benefited from renewed price increases. On the other hand, Japan and in particular the USA, two of the main pillars of economic growth in the past years, have seen slower economic expansion.

Slower growth in the US is a necessary side effect of the fact that the monetary policy stance of the Fed is now no longer expansive. Higher interest rates appear to have already put an end to the housing boom. Hence, consumers no longer see their wealth increasing and the saving rate will soon, in all probability, rise and become positive again, with a further slowdown in consumer demand. Financial markets have already anticipated this effect: the heightened risks for the US economy caused the dollar to depreciate against the euro early in summer. World capital markets have reacted with stock market prices first receding and then recovering, and with long term interest rates going down later in the summer. Thus, volatility has increased notably, albeit not dramatically.

In the second half of this year and in the first half of 2007, the upswing of the world economy will lose momentum in the wake of slower growth in the US. In addition, factors that stress the US economy are or will very likely become burdens for other industrial economies as well: monetary policy has become less expansionary in all important countries; where it is not neutral yet it will continue on this path. In the euro area the stance is not far from neutral, but Japan has a long way to go. Furthermore, many countries are still in a housing market boom similar to that in the US; house prices in these countries are likewise threatened by higher interest rates. In addition, demand in all industrial countries suffers from high prices for commodities and for oil in particular. Finally, fiscal policy will be slightly restrictive in the US, in the euro area, and in Japan in 2006 and 2007. A downturn of the world economy, however, is not forecasted here, because the continued strong growth in emerging markets economies will provide sufficient support. Arguably, these countries have gained influence on the movement of the world economy: their share of world output has grown notably during the last decade and, what is more, economic activity is far less dependent on capital flows from industrial countries than only a few years ago.

The major risks to this forecast come from private US demand that is weakening even more than it is forecasted here, and from a renewed oil price hike. Both points are now and for the foreseeable future standard risk factors, given the high current account deficit of the US economy, and given the political instability of important oil producing countries.

The euro area: upswing at its peak

In the first half of 2006 output in the euro area expanded at the fastest pace in five years. While consumption of private households still lacked momentum, exports and investment activity were – by the moderate standards of the euro area – buoyant. From the supply side, conditions for an upswing in investment have been beneficial at least for the past two years: capital has been cheap due to low short- and long term interest rates and rising equities, and unit labour costs have been growing moderately. Consequently, profits have been high for some time. Now investment activity has reacted.

Leading indicators, however, appear to signal that the upswing has already peaked. Industrial production has ceased to grow during the summer; confidence indicators are in general no longer improving; the Economic Sentiment Indicator for August registered a 1.1 point reduction from July 2006, to 106.7, largely due to the decline in confidence in the industrial sector. Considering the latest information, there has been a downwards revision in the Economic Sentiment Indicator forecast, and we now expect a slight decline in the rest of the year and the first half of next year, subsequently stabilising at around 105.3 points, slightly lower than the August figure. In spite of this, the levels forecast for the next few months continue to be high and greater than those observed in the second half of 2005, when growth started to become consolidated in the euro area. Most revisions for profits of European firms are still upwards, but the positive share has fallen during the summer. There is a number of reasons why demand will expand at a more moderate speed in the second half of 2006 and in the beginning of 2007. While demand from oil exporting countries will still be rising at a high rate, exports will suffer from the (nominal as well as real) appreciation of the euro relative to dollar and yen during spring and summer, and from weaker stimuli from the world economy, in particular from the US. Economic policy will dampen as well: the ECB appears to be determined to reach a neutral monetary stance quickly. This will make capital a bit more expensive. Fiscal policy in 2007 will be clearly restrictive in Italy and in Germany, where the specific measures are already known: at the beginning of 2007, value added tax in Germany will be increased by three percentage points for most items.

What will be supportive for growth are the labour markets in the euro area. Labour market reforms in some countries and wage moderation during the past few years have improved the conditions for more employment. Accordingly, employment growth has slowly been recovering and the unemployment rate has been falling since 2005. These dynamics will continue for some time, strengthening consumer confidence and ultimately private consumption. Therefore, there is a good chance that growth in the euro area will, after a weak spot in the coming autumn and winter, recover to rates slightly above potential in the second half of 2007. Major risks to this forecast are the same as for the world economy as a whole and, specific for the euro area, the risk of an abrupt end of the house price boom in some member countries like France and Spain, with depressing effects on the demand for construction services and the consumption of private households.

Figure 1 Euro Area Economic Sentiment Indicator

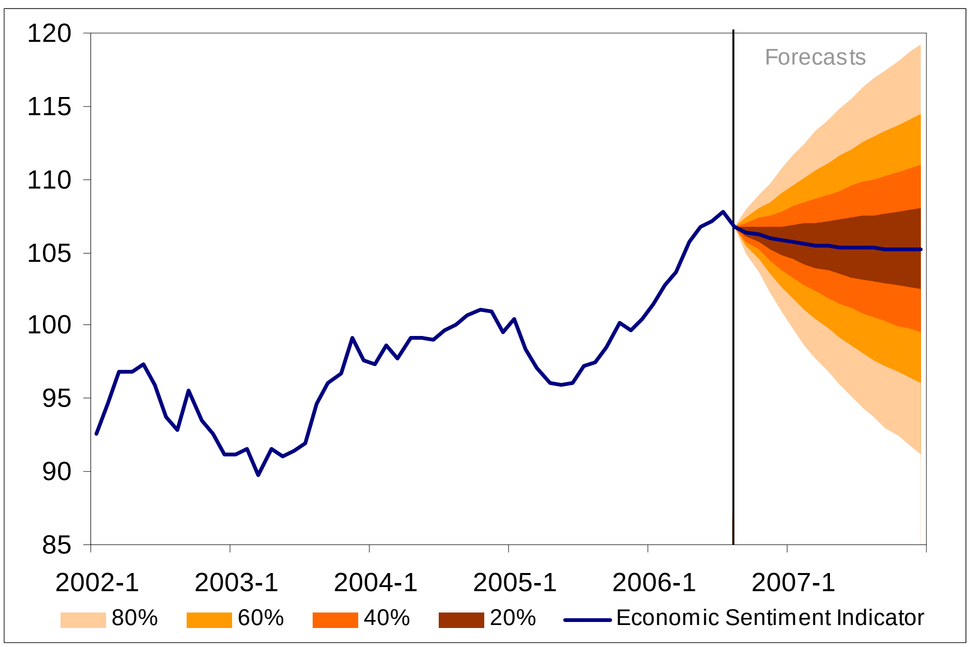
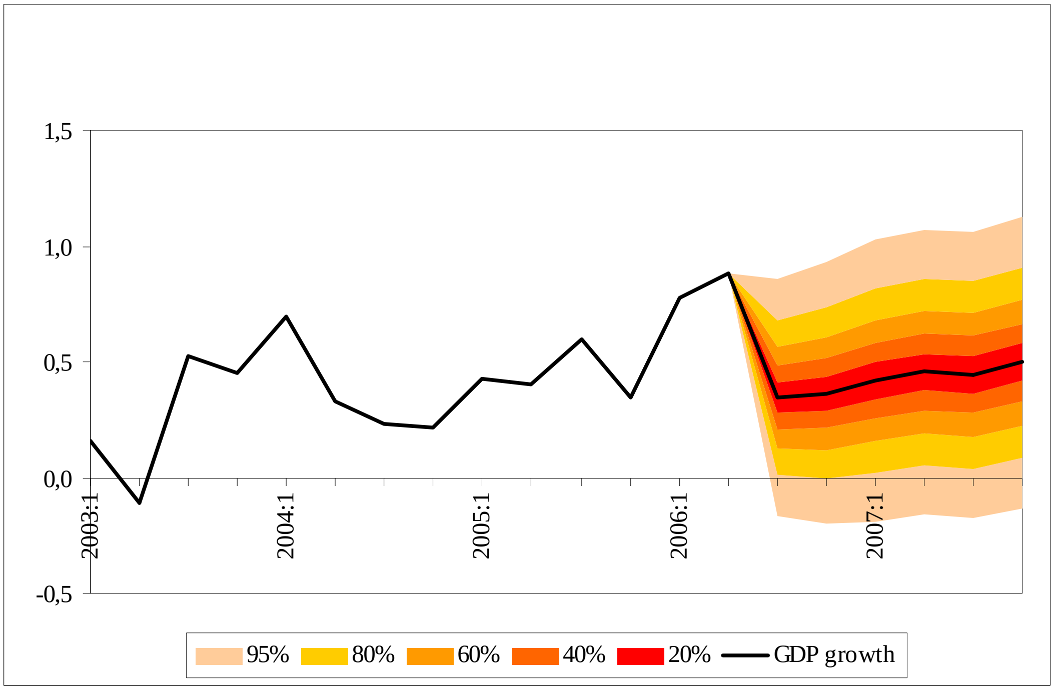
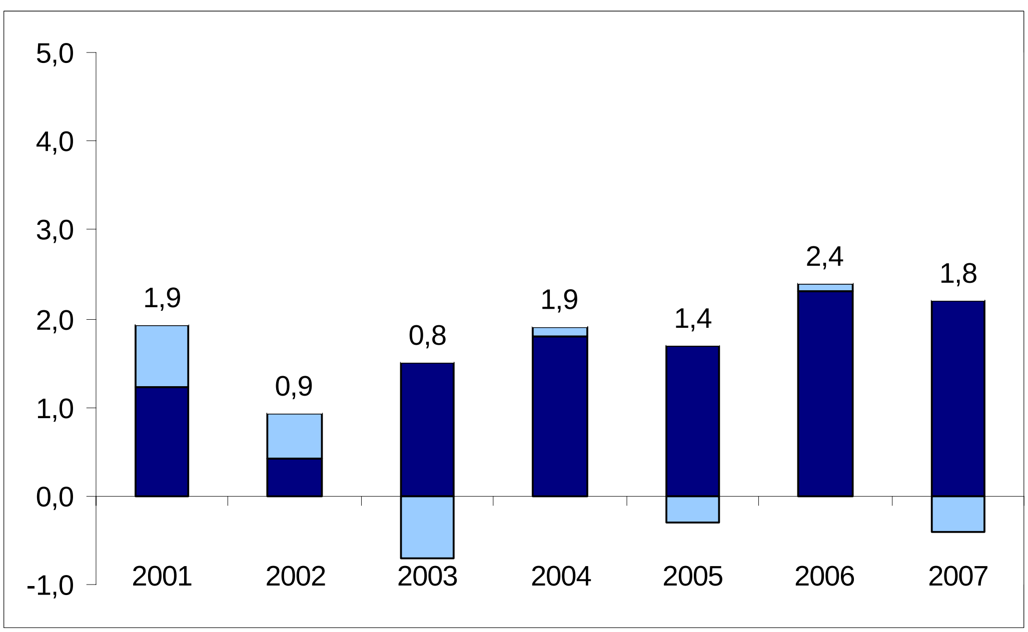


Figure 2 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 3 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above the columns indicate overall GDP growth.

Table 2 Contributions of production sectors

Year	GDP Growth	Agriculture	Industrial	Construction	Services			Net taxes
					Market	Financial	Public	
2001	1.9%	0,0%	0.3%	0.1%	0.6%	0.6%	0.3%	0.1%
2002	0.9%	0.0%	-0.1%	0.0%	0.2%	0.4%	0.3%	0.0%
2003	0.8%	-0.1%	0.1%	0.0%	0.0%	0.4%	0.3%	0.1%
2004	1.9%	0.2%	0.5%	0.1%	0.5%	0.3%	0.2%	0.1%
2005	1.4%	-0.1%	0.2%	0.1%	0.4%	0.5%	0.2%	0.1%
2006	2.4%	0.0%	0.7%	0.1%	0.7%	0.6%	0.2%	0.1%
2007	1.8%	0.0%	0.5%	0.0%	0.5%	0.5%	0.2%	0.1%

From a supply-side perspective, GDP growth for 2006 and 2007 is driven by expansion in services, in particular market and financial services, and in the industrial sector (see Table 2). The services sector will be responsible for more than 60% of GDP growth in 2006 and it is expected that this proportion will continue in 2007.

The average annual rates of growth for different industries classified according to the destination of goods are shown in Table 3. All sectors increase their growth rates for 2006 and the highest recoveries are expected in the intermediate goods and durable goods production sector, pushing IPI growth up to 3.5%. For 2007, the growth rate forecasts for all sectors are lower than in 2006, especially for durable goods, so the IPI growth rate for 2007 will be around 2.5%.

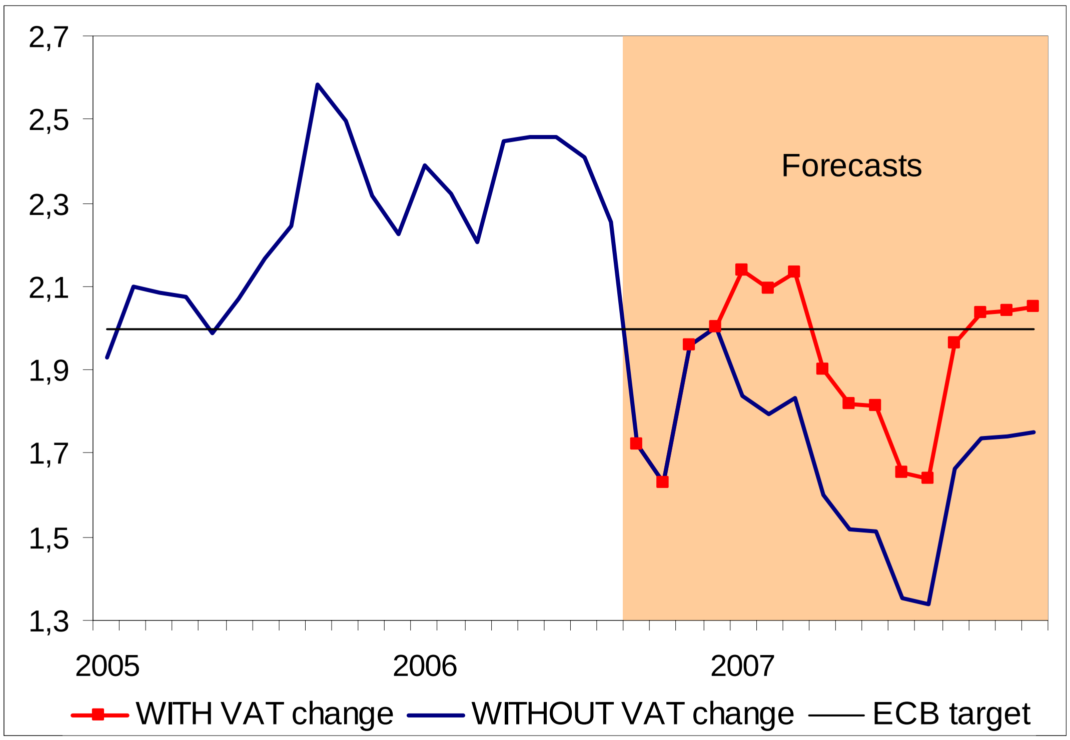
Table 3 Annual average rates for industrial production in the euro area

	2001	2002	2003	2004	2005	2006	2007
Capital	1.8%	-1.6%	-0.1%	3.3%	2.6%	5.0%	3.7%
Durable	-2.0%	-6.3%	-4.4%	0.1%	-0.8%	4.0%	1.7%
Intermediate	-0.8%	-0.1%	0.3%	2.2%	0.7%	4.1%	2.8%
Non Durable	0.8%	0.7%	0.4%	0.6%	0.9%	1.5%	1.0%
Energy	1.4%	1.5%	2.8%	2.0%	1.2%	2.3%	1.5%
Total EMU	0.4%	-0.4%	0.3%	2.0%	1.2%	3.5%	2.5%

With regards to euro area inflation, an improvement in the expectations of both processed food and services prices have been observed, comparing with our last report, and the mean annual core inflation rate for 2006 is revised downwards by 0.1 percentage points to 1.4% (±0.08)[1]. Outside core inflation, an expected increase in unprocessed food prices is sterilized by the improvement in the expectations on energy prices, so the forecast for headline inflation in the euro area for 2006 is also revised downwards by one tenth of percentage point to 2.2% (±0.09).

The price increases due to VAT rates in Germany in 2007 do not imply greater inflationist pressure on the markets and should therefore not be taken into account when designing monetary policy. Based on this assumption, the forecast mean headline inflation rate will be 1.6% (±0.42) and 1.5% (±0.36) for core inflation. Considering the impact on euro area inflation of an increase of three percentage points in the German VAT rate, and assuming that 80-85% of the rise will be transferred to consumer prices, our total inflation forecast for the euro area in 2007 would be around 1.9% (±0.42). In others words, even using this measure of inflation, the likelihood of meeting the ECB target for 2006 is around 50%.

Figure 4 Forecasts for the Inflation in the Euro Area (y-o-y rate)



[1] The values in brackets correspond to 80% confidence intervals calculated with historical errors.

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 4 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics Inc.

The more recent GDP forecasts are quite similar. However, our numbers differ from alternative ones in the structure of demand growth for 2007: we predict a stronger revival of private consumption (due to our more optimistic forecast for the labour market), while fiscal consolidation makes government consumption grow more slowly; in addition, we see fixed capital formation losing more momentum in 2007 than do most alternative forecasts.

Table 4 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
GDP	2.4	1.8	2.1	1.8	2.4	2.0	2.5	2.1	2.2	2.1	2.5	1.8
Priv. Consumption	1.9	2.5	1.7	1.4	1.8	1.7	2.0	1.5	1.5	1.7	1.9	1.4
Gov. Consumption	1.7	0.8	2.0	1.2	2.1	1.5	1.5	1.2	1.9	1.4	1.9	1.3
Fixed Capital Form.	4.0	2.9	4.2	2.4	4.2	3.6	3.8	3.7	3.5	3.7	4.1	3.4
Unemployment rate	7.7	7.3	8.4	8.2	7.9	7.7	na	na	8.2	7.9	7.9	7.6
HICP	2.2	1.9	2.2	2.2	2.3	2.4	2.4	2.4	2.1	2.0	2.3	2.2
IP	3.5	2.5	na	na	na	na	na	na	Na	na	3.2	2.0

EU: European Commission, European Economy, No. 2, 2006; IMF: World Economic Outlook, September 2006; ECB: ECB Monthly Bulletin, June 2006, OECD: Economic Outlook, No. 79, May 2006; Consensus: Consensus Economics Inc., Consensus Forecasts, June 2006. ECB figures correspond to their macroeconomic projections. Numbers in the table refer to the mean of the respective projected interval.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 5 below. For the US and, to a lesser degree, for Japan, GDP growth is expected to slow down during the forecast horizon. Inflation is assumed to abate in the US in 2006 and 2007 because the expansionary monetary policy comes to an end; in addition, we assume more stable energy prices. An oil price of 68 (65) dollars per barrel is expected for the end of 2006 (2007). Deflation in Japan appears to have come to an end in the summer. Recent data on world trade pointed to a modest slowdown. We assume stable exchange rates between the euro and the US dollar and the yen.

Table 5 Variables of the world economy

	2006	2007
US GDP Growth Rate	3.5	2.6
US Consumer Price Inflation	3.6	2.7
US Short Term Interest Rate	5.0	4.9
US Long Term Interest Rate	4.9	5.1
Japan GDP Growth Rate	2.8	2.2
Japan Consumer Price Inflation	0.4	0.6
Japan Short Term Interest Rate	0.3	0.8
Japan Long Term Interest Rate	1.8	2.2
World Trade	9.0	7.2
Oil Price	68	65
USD/Euro Exchange Rate	1.26	1.28
100Yen/Euro Exchange Rate	1.45	1.45

Apart from the development of world trade and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly taken from Consensus Economics (2006) and OECD (2006). Oil price (WTI, end of period) in US dollar per barrel, all other variables in percent.